

DEPARTMENT OF THE NAVY

AUDIT OPINIONS

2005





November 8, 2005

MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (FINANCIAL
MANAGEMENT AND COMPTROLLER)

SUBJECT: Independent Auditor's Report on the Fiscal Year 2005 Department of the Navy
General Fund Financial Statements (Report No. D-2006-017)

The Chief Financial Officers Act of 1990, as amended, requires the Department of Defense Inspector General to audit the accompanying Department of the Navy General Fund Consolidated Balance Sheet as of September 30, 2005 and 2004, the related Consolidated Statement of Net Cost, the Consolidated Statement of Changes in Net Position, the Combined Statement of Budgetary Resources, the Combined Statement of Financing, and the Statement of Custodial Activity for the fiscal years then ended. The financial statements are the responsibility of Department of the Navy management. The Department of the Navy is also responsible for implementing effective internal control and for complying with laws and regulations. We are unable to give an opinion on the Fiscal Year 2005 financial statements of Department of the Navy General Fund because of limitations on the scope of our work. Thus, the financial statements may be unreliable. In addition to our disclaimer of opinion on the financial statements, we are including the required Report on Internal Control and Compliance with Laws and Regulations. The Report on Internal Control and Compliance with Laws and Regulations is an integral part of our disclaimer of opinion on the financial statements and should be considered in assessing the results of the audit.

Disclaimer of Opinion on the Financial Statements

The Assistant Secretary of the Navy (Financial Management and Comptroller) acknowledged to us that material deficiencies still exist in the Department of the Navy General Fund financial statements. Therefore, we did not perform auditing procedures to determine whether material amounts on the financial statements were fairly presented. We did not perform these and other auditing procedures because Section 1008(d) of the FY 2002 National Defense Authorization Act limits the Department of Defense Inspector General to perform only audit procedures required by generally accepted government auditing standards that are consistent with the representations made by management. The Department of the Navy has also acknowledged, and prior audits have identified, the material weaknesses listed in the Summary of Internal Control. These material weaknesses also affect the reliability of certain information contained in the annual financial statements—much of which is taken from the same data sources as the principal financial statements.¹ Therefore, we are unable to express, and we do not express, an opinion on the financial statements and the accompanying information.

¹ The annual financial statements include the principal financial statements, management discussion and analysis, consolidating and combining financial statements, Required Supplementary Stewardship Information, Required Supplementary Information, and Other Accompanying Information.

Summary of Internal Control

In planning our audit, we considered the Department of the Navy internal control over financial reporting and compliance. We did this to determine our procedures for auditing the financial statements and to comply with Office of Management and Budget guidance, but our purpose was not to express an opinion on internal control. Accordingly, we do not express an opinion on internal control over financial reporting and compliance. However, previously identified reportable conditions,² all of which are material, continue to exist in the following areas.

- Accounting and Financial Management Systems
- Fund Balance with Treasury
- Accounts Receivable
- Inventory and Related Property, Net
- General Property, Plant, and Equipment
- Accounts Payable
- Environmental Liabilities
- Problem Disbursements

Material weaknesses are reportable conditions in which internal controls do not reduce (to a relatively low level) the risk of misstatements that are material to the financial statements and that might not be timely detected by employees while performing their normal, assigned functions. Our internal control work would not necessarily disclose all material weaknesses. See the Attachment for additional details on material internal control weaknesses.

Summary of Compliance with Laws and Regulations

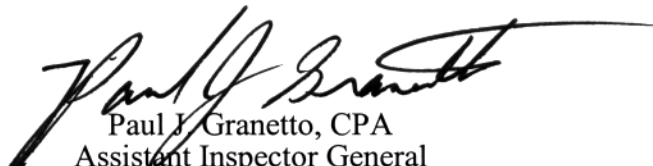
Our work to determine compliance with selected provisions of applicable laws and regulations related to financial reporting was limited because management acknowledged, and prior audits confirm, that instances of noncompliance continue to exist. The Assistant Secretary of the Navy (Financial Management and Comptroller) acknowledged to us that critical financial management and feeder systems do not comply with Federal financial systems requirements, Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level, as required under the Federal Financial Management Improvement Act of 1996. Therefore, we did not determine whether the Department of the Navy was in compliance with all applicable laws and regulations related to financial reporting. See the attachment for additional details on compliance with laws and regulations.

² Reportable conditions are matters coming to the auditor's attention that, in his or her judgment, should be communicated to management because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in financial statements.

Management Responsibility

Management is responsible for:

- preparing the financial statements in conformity with generally accepted accounting principles;
- establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act of 1982 are met; and
- complying with applicable laws and regulations.



Paul J. Granetto, CPA
Assistant Inspector General
Defense Financial Auditing
Service

Attachment:
As stated

Report on Internal Control and Compliance with Laws and Regulations

Internal Control

Management is responsible for implementing effective internal control and for providing reasonable assurance that accounting data are accumulated, recorded, and reported properly and that assets are safeguarded against misappropriation and abuse. Our purpose was not to, and we do not, express an opinion on internal control over financial reporting.

Material Weaknesses. Management acknowledges that previously identified reportable conditions, all of which are material, continue to exist.

Accounting and Financial Management Systems. The Department of the Navy financial systems deficiencies include the inability to implement elements of generally accepted accounting principles and inadequate implementation of the U.S. Government Standard General Ledger. Also, adjusting entries were needed to correct errors caused by differences between accounting systems.

Fund Balance with Treasury. Deficiencies associated with the Fund Balance with Treasury include: unmatched disbursements and collections; the clearing of “suspense” accounts in a timely manner; check discrepancies; undistributed disbursements, collections, and abnormal balances; and an inability to reconcile Department of Navy records with the Department of Treasury’s records.

Accounts Receivable. Intragovernmental accounts receivable may be overstated because of outstanding over-aged reimbursable work orders. Seller-side trading partner data are neither captured nor maintained at a transaction level detail, or may be missing or incomplete because of system deficiencies. Accounts receivable balances with the public may not be complete or accurate. Further, unmatched collections are posted to the accounts receivable account, leaving no audit trail.

Inventory and Related Property, Net. The legacy systems currently being used do not maintain the historical cost data necessary to comply with Statement of Federal Financial Accounting Standards Number 3, “Accounting for Inventory and Related Property.” In addition, completeness issues exist because these legacy systems were not designed to ensure that all of the inventory items are included in the values reported on the Balance Sheet. Some Navy commands have not used the consumption method for expensing Operating Materials and Supplies. Also, some commands are unable to provide Operating Materials and Supplies at the detailed transaction level and only maintain beginning and ending balances.

General Property, Plant, and Equipment. Completeness issues still exist associated with recognizing internal use software and leasehold improvements. Trading partner data for capitalizing assets may not always be recorded. Statement of Federal Financial Accounting Standards No. 23, “Eliminating the Category National Defense Property, Plant, and Equipment,” is currently being implemented.

Accounts Payable. Intragovernmental accounts payable such as Military Standard Requisition and Issue Procedures, fuel payables, and non-PowerTrack transportation charges are not being recorded timely, completely, or accurately. A lack of sufficient systems, processes, and data does not support reconciliation of buyer-side trading partner information. Accounts payable

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with the public are not being recorded timely, completely, or accurately. Some existing procedures create abnormal balances.

Environmental Liabilities. Non-Defense Environmental Restoration Program liabilities are not being reported and, therefore, the line is not ready for audit.

Problem Disbursements. Inaccurate or missing fund accounting codes have resulted in unmatched disbursements and collections requiring use of suspense accounts. The suspense accounts cause difficulty in reconciling Department of the Navy General Fund records with the Department of Treasury's records.

These financial management deficiencies are indications of material weaknesses in internal control that may adversely affect any decision by the Department of the Navy that is based, in whole or in part, on information that is inaccurate because of these deficiencies. Financial information reported by the Department of the Navy also may contain misstatements resulting from these deficiencies.

Compliance with Laws and Regulations

Management is responsible for compliance with existing laws and regulations related to financial reporting. Our work to determine compliance with selected provisions of the applicable laws and regulations was limited because management acknowledged instances of noncompliance, and previously reported instances of noncompliance continue to exist. Therefore, we did not determine whether the Department of the Navy was in compliance with selected provisions of all applicable laws and regulations related to financial reporting. Our objective was not to, and we do not, express an opinion on compliance with applicable laws and regulations.

The Department of the Navy is required to comply with financial management systems reporting requirements. For example, the Federal Financial Management Improvement Act of 1996 requires the Department of the Navy to establish and maintain financial management systems that comply substantially with the Federal financial management system requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. In addition, the Federal Managers' Financial Integrity Act of 1982 requires the Department of the Navy to evaluate the systems and to report annually whether those systems are in compliance with applicable requirements. The Chief Financial Officers Act of 1990 requires the DoD to prepare a 5-year Financial Management Plan describing activities that DoD will conduct during the next 5 years to improve financial management.

The Department of the Navy acknowledged that many of its critical financial management and feeder systems do not comply substantially with the Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. In an attempt to comply with statutory reporting requirements and applicable financial systems requirements, Department of Defense is developing a Department of Defense-Wide Business Enterprise Architecture. The architecture is intended to provide a "blue print" of the Department's financial management systems and processes to initiate a comprehensive financial management reform effort. Until the architecture is fully developed, the Department of the Navy will be unable to fully comply with the statutory reporting requirements. Therefore, we did not perform tests of compliance for these requirements.

Audit Disclosures

The Assistant Secretary of the Navy (Financial Management and Comptroller) acknowledged to us on November 8, 2005, that the Navy General Fund financial management systems cannot provide adequate evidence supporting various material amounts on the financial statements. Therefore, we did not conduct audit work related to deficiencies identified during previous audits of the Department of the Navy.

In addition, we did not perform audit work related to the following selected provisions of laws and regulations: the Antideficiency Act, the Prompt Payment Act, and the Federal Credit Reform Act.

This report does not include recommendations to correct the material internal control weaknesses and instances of noncompliance because previous audit reports contained recommendations for corrective actions.



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

November 8, 2005

MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (FINANCIAL
MANAGEMENT AND COMPTROLLER)

SUBJECT: Independent Auditor's Report on the Fiscal Year 2005 Department of the Navy
Working Capital Fund Financial Statements (Report No. D-2006-0016)

The Chief Financial Officers Act of 1990, as amended, requires the Department of Defense Inspector General to audit the accompanying Department of the Navy Working Capital Fund Consolidated Balance Sheet as of September 30, 2005 and 2004, the related Consolidated Statement of Net Cost, the Consolidated Statement of Changes in Net Position, the Combined Statement of Budgetary Resources, the Combined Statement of Financing, and the Statement of Custodial Activity for the fiscal years then ended. The financial statements are the responsibility of Department of the Navy management. The Department of the Navy is also responsible for implementing effective internal control and for complying with laws and regulations. We are unable to give an opinion on the Fiscal Year 2005 financial statements of Department of the Navy Working Capital Fund because of limitations on the scope of our work. Thus, the financial statements may be unreliable. In addition to our disclaimer of opinion on the financial statements, we are including the required Report on Internal Control and Compliance with Laws and Regulations. The Report on Internal Control and Compliance with Laws and Regulations is an integral part of our disclaimer of opinion on the financial statements and should be considered in assessing the results of the audit.

Disclaimer of Opinion on the Financial Statements

The Assistant Secretary of the Navy (Financial Management and Comptroller) acknowledged to us that material deficiencies still exist that could adversely impact the Department of the Navy Working Capital Fund financial statements. Therefore, we did not perform auditing procedures to determine whether material amounts on the financial statements were fairly presented. We did not perform these and other auditing procedures because Section 1008(d) of the FY 2002 National Defense Authorization Act limits the Department of Defense Inspector General to perform only audit procedures required by generally accepted government auditing standards that are consistent with the representations made by management. The Department of the Navy has also acknowledged, and prior audits have identified, the material weaknesses listed in the Summary of Internal Control. These material weaknesses also affect the reliability of certain information contained in the annual financial statements—much of which is taken from the same data sources as the principal financial statements.¹ Therefore, we are unable to express, and we do not express, an opinion on the financial statements and the accompanying information.

¹ The annual financial statements include the principal financial statements, management discussion and analysis, consolidating and combining financial statements, Required Supplementary Information, and Other Accompanying Information.

Summary of Internal Control

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- Other Liabilities

Material weaknesses are reportable conditions in which internal controls do not reduce (to a relatively low level) the risk of misstatements that are material to the financial statements and that might not be timely detected by employees while performing their normal, assigned functions. Our internal control work would not necessarily disclose all material weaknesses. See the Attachment for additional details on material internal control weaknesses.

Summary of Compliance with Laws and Regulations

Our work to determine compliance with selected provisions of applicable laws and regulations related to financial reporting was limited because management acknowledged, and prior audits confirm, that instances of noncompliance continue to exist. The Assistant Secretary of the Navy (Financial Management and Comptroller) acknowledged to us that many of the financial management systems do not comply substantially with Federal financial management system requirements, generally accepted accounting principles, and the U.S. Government Standard General Ledger at the transaction level. Therefore, we did not determine whether the Department of the Navy was in compliance with all applicable laws and regulations related to financial reporting. See the Attachment for additional details on compliance with laws and regulations.

Management Responsibility

Management is responsible for:

- preparing the financial statements in conformity with generally accepted accounting principles;

² Reportable conditions are matters coming to the auditor's attention that, in his or her judgment, should be communicated to management because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in financial statements.

- establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act are met; and
- complying with applicable laws and regulations.



Paul J. Granetto, CPA
Assistant Inspector General
Defense Financial Auditing
Service

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As stated

Report on Internal Control and Compliance with Laws and Regulations

Internal Control

Management is responsible for implementing effective internal control and for providing reasonable assurance that accounting data are accumulated, recorded, and reported properly and that assets are safeguarded against misappropriation and abuse. Our purpose was not to, and we do not, express an opinion on internal control over financial reporting.

Material Weaknesses. Management acknowledged that previously identified reportable conditions, all of which are material, continue to exist.

Accounting and Financial Management Systems. The Department of the Navy financial management systems do not comply fully with generally accepted accounting principles, and the U.S. Government Standard General Ledger at the transaction level. As a result, Department of the Navy financial management and feeder systems cannot provide adequate evidence supporting various material amounts on the financial statements.

Fund Balance with Treasury. The Navy Working Capital Fund activities do not reconcile cash accounts to the Department of Treasury cash account balance on a consistent basis. In addition, system interfaces do not exist between the financial reporting systems causing unmatched disbursements and collections.

Accounts Receivable. Department of Navy does not reconcile subsidiary records to corresponding general ledger accounts, resulting in a control weakness and the loss of an audit trail. Navy also posts unmatched collections to accounts receivable using journal vouchers, leaving no audit trail. Trading partner adjustments posted to intragovernmental accounts receivable are not always supported by detailed transactions. Navy also does not always record recognition and collection of public accounts for contract overpayments, travel advances, and employee debt.

Inventory and Related Property, Net. Navy Working Capital Fund Supply Management activities record inventory at latest acquisition cost. To comply with generally accepted accounting principles, latest acquisition cost must be converted to approximations of historical cost. Adequate data, processes, and methodologies do not exist to accurately make this conversion.

General Property, Plant, and Equipment. Navy Working Capital Fund Supply Management Business Area does not properly record assets and depreciation within its accounting systems. In addition, Navy does not capture or report buyer-side trading partner information.

Accounts Payable. This line item is adversely affected by insufficient and inconsistent reconciliations and a lack of direct system interfaces, resulting in matching difficulties, undistributed disbursements, and the inability to capture trading partner information.

Other Liabilities. Unsupported, undistributed disbursements need to be resolved. The Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer, the Defense Finance and Accounting Service Cleveland, and Department of Navy staff need to work this

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issue jointly, analyzing amounts posted for contract accruals to determine if they are properly recorded in this line item.

These financial management deficiencies are indications of material weaknesses in internal control that may adversely affect any decision by the Department of the Navy that is based, in whole or in part, on information that is inaccurate because of these deficiencies. Financial information reported by the Department of the Navy also may contain misstatements resulting from these deficiencies.

Compliance with Laws and Regulations

Management is responsible for compliance with existing laws and regulations related to financial reporting. Our work to determine compliance with selected provisions of the applicable laws and regulations was limited because management acknowledged instances of noncompliance, and previously reported instances of noncompliance continue to exist. Therefore, we did not determine whether the Department of the Navy was in compliance with selected provisions of all applicable laws and regulations related to financial reporting. Our objective was not to, and we do not, express an opinion on compliance with applicable laws and regulations.

Federal Financial Management Improvement Act of 1996. The Department of the Navy is required to establish and maintain financial management systems that comply substantially with Federal financial management system requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. The Department of the Navy acknowledged to us that many of the financial management systems do not comply substantially with Federal financial management system requirements, generally accepted accounting principles, and the U.S. Government Standard General Ledger at the transaction level.

Federal Managers' Financial Integrity Act of 1982. The Department of the Navy is required to evaluate its financial systems and to report annually on whether those systems are in compliance with applicable requirements. The DoD is in the process of developing a Business Enterprise Architecture through its Financial Management Modernization Program. The architecture is intended to improve the effectiveness of DoD financial and nonfinancial systems in providing financial information. Until the architecture is fully developed, the Department of the Navy will be unable to fully comply with statutory reporting requirements. Therefore, we did not perform tests of compliance for these requirements.

Audit Disclosures

The Assistant Secretary of the Navy (Financial Management and Comptroller) acknowledged to us on November 8, 2005, that the Department of the Navy Working Capital Fund financial management systems cannot provide adequate evidence supporting various material amounts on the financial statements. Therefore, we did not conduct audit work related to deficiencies identified during previous audits of the Department of the Navy.

In addition, we did not perform audit work related to the following selected provisions of laws and regulations: Antideficiency Act, the Prompt Payment Act, and the Federal Credit Reform Act.

This report does not include recommendations to correct the material internal control weaknesses and instances of noncompliance because previous audit reports contained recommendations for corrective actions.